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TREASURY FOR OASIA - MILLS AND LEICHTER
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TAGS: ECON EFIN PGOV TU
SUBJECT: TURKEY'S ECONOMY: SOME POSITIVE SIGNS, BUT LITTLE LONG-TERM CONFIDENCE

REF: ISTANBUL 0671

¶1. (SBU) Summary: The rapid end of the Iraq war, prospect of U.S. and IMF money, and a global emerging market rally have combined to boost the Turkish currency and reduce interest rates substantially in recent weeks. Meanwhile, exports and industrial production continue to rise, while inflationary expectations have fallen, increasing the prospects for Turkey meeting its 2003 growth and inflation targets. On the other hand, conversations with foreign investment bankers and local business executives reveal little confidence in the GOT's ability to build on these positive trends and to manage the economy effectively in the year ahead. The bottom line: although the mood is more buoyant than two months ago, investors realize the fundamentals have not changed and thus remain reluctant to look beyond the next several months. End Summary

¶2. (SBU) Although they have weakened slightly in the past few days, Turkish markets have staged a huge rally in the past seven weeks. From their March 25 lows, the lira has strengthened from TL 1.750 million/dollar to TL 1.485 million/dollar, and yields on the benchmark t-bill have fallen from 73.5 percent to just over 50 percent. Investment bankers (we have spoken this week to Goldman Sachs, Deutschbank, Merrill Lynch, HCIstanbul, ING Barings, and several of their clients) attribute this rally to a combination of positive developments: the rapid, successful conclusion of the Iraq war (with relatively limited impact on Turkey's economy), the prospect of significant U.S. financial assistance, completion of the Fourth Review under the IMF program, and the post-war global rally in emerging markets, as investor risk appetite has returned. Central Bank Markets Department General Manager Akil Ozcay told us May 14 that two internal factors also played a role: the shift by Turkish depositors of about 7 percent ($3 billion) of their foreign exchange deposits to lira deposits at the time the lira reached its low (i.e., a significant bet on the lira); and, related to that, some shift from dollars to lira as people made payments under Turkey's "tax peace" program. (Note; Of course, some of the lira's rally against the dollar reflects the dollar's global weakness. End note)

¶3. (SBU) The real economy also has shown signs of improvement (reftel), although not as dramatic as in financial markets. Industrial production rose 5.6 percent in March (year-on-year), above expectations, and 7.5 percent for the quarter. Exports increased 27.5 percent in March (and 27 percent for the first quarter), and the Exporters Association estimates strong growth for April as well. March's sharp (44.8 percent) rise in imports suggests growing domestic demand, though it is also raising concerns about the size of Turkey's current account deficit this year. In the past week, State Minister for Trade Kursad Tuzmen has joined a growing chorus of exporters warning that the lira's appreciation is hurting their competitiveness. Oyak Executive VP Ergun Okur told us May 14 that the company was now losing money on some auto exports because of the lira's strength.

¶4. (SBU) The Central Bank's latest inflationary expectations survey also came in positive, as expectations for year-end CPI fell from 28 to 26.6 percent. Central Bank officials, along with Treasury U/S Ibrahim Canakci, remain hopeful that they can still hit the 20 percent CPI target for the year, though they acknowledge they will miss the 17 percent WPI target. The seasonal decline in agricultural prices, combined with the strength of the lira, lower oil prices, and declining expectations, should all help keep inflation in

check in the months ahead.

¶5. (SBU) That is the good news. The bad news is that, based on our conversations with local business executives and several groups of foreign investment banks in the past week, there is little optimism that the government will be able to build on recent positive developments. As Deutschbank economist Marco Annunziato put it, "the recent confluence of events gives Turkey a great opportunity to begin a virtuous economic cycle, but we have been struck in our conversations by the complete lack of confidence (in Istanbul) in this government's ability to take advantage of the opportunity." Turkish Young Businessmen's Association Ankara Chairman Murat Sarayli said Turkish companies are still reluctant to invest (other than those involved in exports) because they cannot plan beyond the next 3-6 months.

¶6. (SBU) Investment banker contacts note that the government continues to move slowly and half-heartedly to meet IMF conditions, while intermittently offering populist measures that undermine whatever credibility it has built up via the reform measures it has taken. As a result, they say, financial markets are likely to remain vulnerable to even minor shocks, with little prospect of a long-term, steady decline in interest rates of the sort that would reduce concerns about debt sustainability. They predict that, in the next few months, investors will begin to focus on Turkey's very large external debt repayment schedule for 2004, and will want to see strong evidence that the government is faultlessly implementing its reform program. The bottom line, therefore, is that, while the government has been able to lengthen t-bill maturities to some extent, there remains little appetite -- among both financial and non-financial investors -- for medium and long-term investing.

¶7. (SBU) Comment: Three times in the past year, nominal interest rates on t-bills have fallen to the 50 percent level, only to rise again due to policy failings or political developments (eg. the declining health of then-PM Ecevit last year). Based on our latest conversations, our sense is that investors almost expect a repeat of this pattern. One foreign investment banker told us his company was making a list of the "trigger points" that would cause markets to fall again. Changing this mentality will require improved economic policy performance (eg. surprising the markets by quickly completing the Fifth Review) at a time when many fear all the good news will encourage GOT complacency.

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